[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: COMPLIANCE AND TAX ADMINISTRATION

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

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PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet [1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance in connection with the respective committee review of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets, and it describes and analyzes tax provisions and proposals relating to compliance and tax administration, including the return-free system and tax amnesty.

The pamphlet describes present-law tax provisions and the tax reform proposal made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration proposal"), the 1984 Treasury Department recommendations to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury report"), Congressional proposals (identified by the primary sponsors), and other related proposals.

The first part of the pamphlet is an overview. The second part discusses information reporting, penalties, interest provisions, estimated tax payments by individuals, the return-free system, tax amnesty and related compliance measures, the audit level, and complexity in withholding due to differing definitions of wages.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Compliance and Tax Administration* (JCS-32-85), July 30, 1985.

I. OVERVIEW

In the past several years, Congress has become increasingly concerned about the problems of tax compliance. Congress has consequently enacted a number of provisions designed to increase compliance. While the vast majority of these provisions were relatively non-controversial and appear to be functioning as intended, several have been extraordinarily controversial, and two have been repealed because of that controversy.[2]

This recent history illustrates that, in considering compliance measures, competing (and often conflicting) values must be balanced. Compliance measures are viewed by many as beneficial, in that they increase Federal revenues without raising marginal rates. Additionally, the perception that some taxpayers are not fully complying with the tax laws may feed on itself, encouraging additional taxpayers not to comply. Conversely, increasing compliance may strengthen the tax system overall by increasing the perception of equity. The price of increased compliance frequently is, however, an increase in the reporting and recordkeeping burden on taxpayers, and a correlative perception of intrusiveness by the Internal Revenue Service (IRS) into the lives of taxpayers.

A significant development has been the apparently increasing willingness on the part of taxpayers to take aggressive positions on their tax returns. A growing, though still relatively small, number of taxpayers appear willing to go so far as to take wholly unjustified, fraudulent positions. Paralleling this development has been the increasing trend of abusive tax shelters to move to tax haven jurisdictions. These developments are generally not remediable by the types of compliance measures traditionally considered by Congress.

An additional difficulty encountered in considering compliance measures is the constantly increasing complexity in, and sophistication of, the financial affairs and business arrangements of taxpayers. This constantly increasing complexity and sophistication may imply that compliance measures will need to be expanded and reevaluated throughout the future and that consideration of compliance measures will never be completed.

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[2] Withholding on interest and dividends (P.L. 98-67) and contemporaneous automobile recordkeeping (P.L. 99-44) were both repealed.

II. SPECIFIC PROVISIONS AND PROPOSALS

A. Information Reporting

Background and Present Law

In general

Taxpayers complete tax returns by reporting income, claiming deductions, and computing tax credits. In addition, some of these items are described on information returns that third parties supply to the IRS and to the taxpayer. These information returns remind the taxpayer to report the proper amounts and enable the IRS to verify that the taxpayer has done so. Until recently, the focus of the information reporting requirements of the Code was on income. Not all items of income are, however, subject to information reporting. Recently, some deductions have also been included in information reporting.

Information reports generally must include the name, address, and taxpayer identification number (for individuals, the social security number) of the taxpayer. The IRS generally must have the taxpayer identification number to match the information report with the taxpayer's tax return.

Table 1 presents the voluntary reporting percentage for various types of income, as calculated by the IRS for 1981.[3]

Table 1.—Individual Income Tax Net Income Reporting Compliance, by Type of Income, 1981

[Amounts in millions of dollars]

Type of income	Reported on tax returns	Should have been reported	Voluntary reporting percentage
Wages and salaries	$1,455,154	$1,549,735	93.9
Dividends	44,945	53,692	83.7
Interest	129,112	149,591	86.3
Capital gains	25,934	43,661	59.4
Nonfarm proprietor income (except informal supplier income)	53,580	106,522	50.3
Farm proprietor income	−2,051	11,095	(1)
Partnership and small business corporation income	14,859	31,604	47.0
Informal supplier income	4,465	21,545	20.7
Pensions and annuities	58,458	67,257	86.9

[3] The data for 1981 is projected; it is the most recent currently available.

Table 1.—Individual Income Tax Net Income Reporting Compliance, by Type of Income, 1981—Continued

[Amounts in millions of dollars]

Type of income	Reported on tax returns	Should have been reported	Voluntary reporting percentage
Rents	2,564	6,890	37.2
Royalties	4,361	7,131	61.2
Estate and trust income	3,869	5,215	74.2
State income tax refunds, alimony, and other income	11,700	18,866	62.0
Total income	1,806,950	2,072,804	87.2

[1] The voluntary reporting percentage cannot be calculated, since the reported amount is a negative figure.

Source: IRS Research Division, *Income Tax Compliance Research* (July 1983), p. 22.

Wages and salaries

Wages and salaries are subject to comprehensive information reporting (sec. 6051) and withholding (sec. 3402). The percentage of voluntary reporting of wages is the highest of all major income types. The most significant area of non-compliance involves wages paid in forms other than cash, such as fringe benefits.

Dividends and interest

Dividends and interest are subject to comprehensive information reporting for payments to individuals (secs. 6042, 6044, and 6049). Payments to most other recipients (such as corporations) are exempt from reporting. Interest and dividend payments are also subject to backup withholding, which becomes effective if the taxpayer has not furnished his correct taxpayer identification number (for individuals, the social security number), if the taxpayer underreports interest or dividends on his tax return, or if the taxpayer fails to certify that he is not subject to backup withholding (sec. 3406).[4]

Capital gains

In 1982, Congress reenacted, as part of TEFRA, the provision of the Code (sec. 6045) providing that, when required by the IRS, brokers must file information reports on the business they transact for customers. These reports provide most of the information currently received by the IRS on capital transactions.[5] Not all capital transactions are, however, reported under this provision.[6] To date, the

[4] Backup withholding was enacted in 1983 (P.L. 98-67), in legislation that repealed the general interest and dividends withholding provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

[5] Additionally, these reports include a few ordinary income items.

[6] Additionally, transactions not involving a broker, such as a sale between two individuals, are not subject to this reporting.

IRS has issued regulations requiring reporting only of gross proceeds of sales of securities, commodities, regulated futures contracts, and precious metals.[7]

Proprietor income

Some payments made to proprietors, which are generally small, unincorporated businesses, are subject to information reporting (sec. 6041). Several problems exist with respect to these reporting requirements. First, only persons engaged in a trade or business are required to report. Consequently, there will be little information reporting with respect to payments made by individuals to proprietors who are engaged in retail sales. The second difficulty is that the level of compliance with this information reporting requirement is generally lower than the level for other information reporting requirements. This may be caused by the general nature of this reporting requirement, which results in taxpayers not being fully aware of the exact standards they must follow. The third difficulty is that this reporting requirement has a $600 threshold, which is higher than the threshold for many other types of information reporting.

Partnership and small business corporation income

Partners of a partnership or shareholders of an S corporation receive reports from these entities enumerating income and deductions. These items flow through these entities (which do not pay taxes) to the partners' or shareholders' tax returns. In 1982, as part of TEFRA, partnerships were made subject to audit at the partnership (rather than the partner) level. Parallel rules were provided for S corporations.

Informal supplier income

Informal suppliers are individuals who operate businesses, such as home repairs, domestic service, or roadside food stands, as a sideline to their major employment. A significant percentage of informal supplier activity occurs in the legal sector [8] of the underground economy. Little information reporting exists on this type of income. In fact, because of the informal nature of these businesses, the lack of books and records, and the propensity of these individuals to deal in cash, it is difficult to obtain any information on this type of income.

Pensions and annuities

Pension and annuity payments are subject to a system of comprehensive information reporting and voluntary withholding (sec. 3405). In addition, these payments are also subject to mandatory backup withholding if the taxpayer has not furnished his correct taxpayer identification number (for individuals, the social security number).

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[7] The IRS regulations were issued in May 1983. Data is not yet available to indicate the effect of these regulations on voluntary compliance.

[8] This means that the transactions themselves are legal, rather than that the income is reported as legally required for tax purposes.

Rents and royalties

As with proprietor income, some payments of rents and royalties are subject to information reporting (sec. 6041). Because only persons engaged in a trade or business are required to report, there are significant gaps in this information reporting, especially with respect to rents. Also, it appears that some taxpayers required to report are not doing so.

Estate and trust income

Beneficiaries of an estate or trust receive reports from these entities enumerating income and deductions.

Other income

State and local income tax refunds are includible in income if the taxpayer received a tax benefit from itemizing deductions for State and local income taxes. These refunds are subject to information reporting (sec. 6050E).

Alimony is generally deductible by the person who paid it and includible in the income of the person who received it. Alimony is not subject to information reporting. The Tax Reform Act of 1984 included a provision authorizing the IRS to require that the recipient of alimony give to the payer of alimony the recipient's taxpayer identification number (the social security number). The payer of the alimony would then report the recipient's taxpayer identification number on the payer's tax return. These procedures were designed to facilitate the matching of the claimed deductions of the payer with the reported income of the recipient.

Unemployment compensation is generally subject to information reporting (sec. 6050B). Social security benefit payments are also subject to information reporting (sec. 6050F).

Exemptions

Taxpayers may claim exemptions on their tax returns for themselves, their spouses, and their dependents. Most dependents are minor children; some, however, are adults. For example, if the taxpayer's parents live with the taxpayer, if the parents have no income, and the taxpayer provides more than half their support, the taxpayer may claim the parents as dependents.

The taxpayer and the taxpayer's spouse must report their taxpayer identification numbers (for individuals, the social security number) on their tax return. There is no requirement that the social security numbers of dependents be included.

The IRS estimates that, for 1981, $8.1 billion in overstated exemptions were claimed on individual tax returns. This represents approximately 5 percent of the total misreporting of income and deductions for that year.[9]

Non-itemized deductions

Payments to an IRA generally must be reported on an information return. The Code authorizes the IRS (sec. 6047) to require information reporting on payments to a Keogh (self-employment)

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[9] Source: IRS Research Division, *Income Tax Compliance Research* (July 1983), p. 20.

plan; to date, the IRS has not required reporting on Keoghs. Unreimbursed moving expenses and employee business expenses also are not subject to information reporting.

Itemized deductions

Mortgage interest payments received by persons in a trade or business are generally subject to information reporting (sec. 6050H). However, payments received by an individual who, for example, is holding a mortgage on a former residence, are not subject to information reporting.

Medical expenses, taxes, other types of interest, charitable contributions, and casualty and theft losses are not currently subject to information reporting.

Tax credits

Generally tax credits are not currently subject to information reporting. The IRS can, however, compute the earned income credit based on information reporting on other amounts (such as wages) that the IRS receives. The IRS can also verify most aspects of the credit for the elderly and disabled based on information reports.[10]

Possible Proposals

The scope of some of these information reporting provisions could be expanded to increase compliance. Expanded information reporting for taxable fringe benefits, capital gains, and royalties might be considered. Also, clarifying the general information reporting requirements could be beneficial. Enhancing the substantiation and verification requirements for charitable contributions might be considered. It would also be possible to increase the scope of the current withholding system. For example, withholding on pensions might be made mandatory instead of voluntary. It would also be possible to require that taxpayers list the social security numbers of their dependents, in addition to their own social security numbers, on their tax returns.

In addition, the Administration proposal advocates the elimination or modification of several of the substantive provisions underlying these information reporting requirements. The interaction of these substantive reform provisions with the information reporting and other compliance provisions should be considered.

Analysis

Capital gains

It would be possible to expand the current broker reporting regulations to include real estate transactions. There is significant noncompliance with respect to these transactions. Requiring that an information report be completed at closing might not be a significant incremental burden on the parties.[11] Since many real estate

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[10] Technically, income tax withholding from wages is treated as a credit; amounts withheld are reported to the IRS on Form W-2.

[11] Currently, information reporting may be required for commercial and large residential transactions to avoid FIRPTA withholding. This provision could be expanded.

transactions involve a broker, this reporting would encompass a substantial percentage of all real estate transactions. In order for this information reporting to be most useful to the IRS, the taxpayer identification number (for individuals, the social security number) of the seller would also need to be reported.

Alternatively, the IRS could acquire the same information by requiring reporting by the local governmental unit that records title to the property. Another alternative might be for the IRS to purchase commercial lists of real estate transactions for those portions of the country where these lists are available. Neither of these alternatives, however, generally includes the taxpayer identification number of the seller in its records. Consequently, these alternatives may be less effective than broker reporting would be as a tool to increase compliance with respect to these real estate transactions.

Reporting on frequent flyer bonuses

It has been proposed that airlines provide information reporting with respect to "frequent flyer" benefits under programs where free flights or other benefits are received by passengers, including employees who receive these benefits on the basis of flights that were paid for by their employer.[12] Likewise, information reporting could be required with respect to similar benefits received by "frequent users" of services such as hotels or rental automobiles. Issues raised by such proposals include valuation difficulties (e.g., free flight benefits may be subject to various restrictions), and determining the time of valuation (when the benefits are earned or when the benefits are used).

Royalties

It would be possible to clarify that existing information reporting requirements apply to royalty payments. Additionally, consideration might be given to lowering the reporting threshold from its current level of $600.

Clarification of general requirements

It would be possible to clarify the general information reporting requirements in several ways. First, it would be possible to increase the specificity of the provisions describing the types of payments that must be reported. Second, consideration could be given as to whether the current exceptions from information reporting are appropriate. For example, payments to corporations are generally exempt from information reporting. While this might be appropriate for large corporations that maintain adequate books and records, that employ independent accountants, and whose returns are frequently audited by the IRS, these considerations might not apply with equal force to very small corporations. Additionally, some might view present law, which requires information reporting on payments to an unincorporated sole proprietor, but exempts from reporting payments to that same entity once it incorporates, as anomolous.

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[12] H.R. 2257, introduced by Mr. Ford (of Tenn.), would require information reporting by airlines on frequent flyer bonuses.

Charitable contributions

Enhancing the substantiation and verification requirements for charitable contributions might be considered. Verification of contributions of currency can be particularly difficult. Thus, taxpayers making cash contributions in excess of a specified minimum dollar amount could be required to obtain a receipt in order to claim a deduction.

In addition, there appear to be compliance problems when taxpayers purchase (or make "donations" in exchange for) goods or services from a charitable organization. Only the excess (if any) of the price paid over the fair market value of the purchase is deductible. Thus, if a taxpayer purchases from a charitable organization for $10 a dinner the fair market value of which is $10, the taxpayer is not entitled to any deduction. Similarly, if a taxpayer purchases from a charitable organization for $50 a theatre ticket the fair market value of which is $40, the taxpayer is entitled to a deduction of $10. It might be possible to require that the charitable organization indicate the specific amount that is deductible, if any, when taxpayers purchase goods or services from a charitable organization; some charitable organizations currently do this.

Withholding on pensions

It would be possible to repeal the provision permitting individuals to elect not to have withholding apply to designated distributions. Thus, mandatory withholding could be imposed on the taxable portion of a distribution under any pension. annuity, or other deferred compensation plan. Alternatively, mandatory withholding could be required only for payments to persons residing abroad.

Some have criticized the current withholding system for pension or annuity income on the grounds that it permits taxpayers to delay or avoid tax on benefits that are includible in gross income. The present rules requiring special notices and permitting recipients to elect not to have withholding have also been criticized by plan administrators because of the administrative burdens imposed on them. They have also reported that the rules often confuse retirees.

Some have also suggested that an elective withholding system does not accomplish the intended goals of Congress. It is argued that many taxpayers elect not to have withholding apply to them, and that therefore the provisions have not reduced the recordkeeping and estimated tax burdens of the elderly.

On the other hand, some pension experts have argued that mandatory withholding on deferred compensation would result in excessive tax payments by unsophisticated people. They point out that, under existing law, pension payments during the first three years after payments begin may not be taxable.[13]

In addition, those who oppose mandatory withholding point out that special rules would be required so that no withholding tax would be imposed on amounts transferred between pension plans or individual retirement accounts in a tax-free rollover. They be-

[13] The Administration has proposed the repeal of this three-year rule.

lieve that the rules necessary to accommodate this concern would cause confusion.

The current withholding system for pension or annuity income does not apply to the taxable portion of social security payments. It would be possible to make these taxable payments subject to withholding, either through the current voluntary withholding system or through mandatory withholding. Withholding on these taxable payments could alleviate the burden on the elderly of making estimated tax payments.

Social security numbers of dependents

It would be possible to require that taxpayers claiming a dependent on their tax return list the social security number of the dependent on the tax return. This could apply to all dependents, whether minor children or adults.

Those that advocate this proposal do so because it would enable the IRS to verify more completely the accuracy of claimed exemptions for dependents. Thus, the IRS would be able to reduce claims of unwarranted exemptions and enhance compliance. Others, however, point out that this proposal could inconvenience some taxpayers. This could particularly be true for parents of new-born infants. They would have to apply for a social security number for their child soon after the child is born; currently, many parents wait several years before applying for a social security number for their child. They are not, however, required to wait; the Social Security Administration generally will upon application issue a social security number for a child immediately after birth.

Interaction with substantive reform

The elimination of some substantive provisions may simplify information reporting. If, for example, the deduction for State and local income, sales, and property taxes were repealed as the Administration proposes, the compliance problems associated with these provisions would also be eliminated. Additionaily, current information reporting on State and local income tax refunds could be repealed. If, on the other hand, these deductions were retained, it might be appropriate to provide for increased information reporting to ensure that only proper deductions are claimed. For example, State and local jurisdictions could be required to report to the IRS on real and personal property taxes. In addition, they could be required to report on State and local income taxes withheld or otherwise paid.[14]

Adoption of other aspects of the Administration proposal may require more information reporting than would be necessary if present law were maintained. For example, the IRS may be able to enforce more effectively the proposed limitations on the deductibil-

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[14] Although amounts withheld are shown on most information reports for wages (Form W-2), they are not required by the IRS to be shown. The information that is shown is not currently retrieved by the IRS. It is possible that increased standardization of the Form W-2 would be necessary to permit the IRS to retrieve this information. Even if this were done, information reporting by the State or local government would still be necessary for estimated tax payments and payments of taxes with the tax return, since these amounts are never shown in a Form W-2.

ity of interest if additional information reporting on potentially deductible interest were required.

B. Penalties

1. Negligence and Fraud Penalties

Background and Present Law

Negligence

Taxpayers are subject to a penalty if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations (but without intent to defraud) (Code sec. 6653(a)). There are two components to this penalty. The first component is 5 percent of the total underpayment, where any portion of the underpayment is attributable to negligence or intentional disregard of rules or regulations. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to negligence is $200, the amount of the penalty is $50 (5 percent of $1,000). The second component is an amount equal to one-half the interest rate that taxpayers must pay on underpayments of tax multiplied against the portion of the underpayment attributable to negligence or intentional disregard, for the period beginning on the last day prescribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier).

Generally, once the IRS has determined that negligence existed, the burden is on the taxpayer to establish that the IRS' determination of negligence is erroneous. The taxpayer must meet a higher standard in the case of interest or dividend payments (sec. 6653(g)). This section provides that if the taxpayer fails to include in income an interest or dividend payment shown on an information return, the portion of the underpayment attributable to this failure is treated as due to negligence in the absence of clear and convincing evidence to the contrary. The effect of this provision is that the IRS may automatically assert the negligence penalty in these circumstances, and the taxpayer must present clear and convincing evidence that no negligence was involved in order to avoid the penalty.

The negligence penalty applies only to underpayments of income taxes, gift taxes, and the windfall profits tax.

Fraud

Taxpayers are also subject to a penalty if any part of a underpayment of tax is due to fraud (sec. 6653(b)). This penalty is in lieu of the negligence penalty. There are two components to the fraud penalty. The first component is 50 percent of the total underpayment, where any portion of the underpayment is attributable to fraud. Thus, if a taxpayer has underpaid $1,000 in taxes and the portion due to fraud is $500, this component of the penalty is $500 (50 percent of $1,000). The second component is an amount equal to one-half the interest rate that taxpayers must pay on underpayments of tax, multiplied against the portion of the underpayment attributable to fraud, for the period beginning on the last day pre-

scribed for payment of the underpayment (without regard to any extension) and ending on the date of the assessment of the tax (or the date of payment of the tax, if that date is earlier). The burden of proof is on the IRS to establish that fraud existed (sec. 7454(a)).

Reliance on counsel

Generally, a taxpayer can avoid the application of the negligence penalty if the taxpayer reasonably relied on competent tax counsel who was fully informed of the relevant facts. The same principle applies to the fraud penalty. The principle does not apply, however, to the penalty for failure to file a return (sec. 6651(a)(1)).[15] Reliance on an attorney will not enable the taxpayer to avoid application of the failure to file penalty.

Application of these penalties

Congress has expressed concern that the negligence and fraud penalties are not being applied in a large number of cases where their application is fully justified.[16]

Possible Proposals

It would be possible to modify the negligence and fraud penalties in several ways. First, both the negligence and fraud penalties could be applied only to the portion of the understatement that is attributable to negligence or fraud, rather than to the entire amount of the understatement. Second, the special negligence penalty applicable to failure to include in income interest or dividends reported on an information return could be expanded to include failures with respect to other information returns. Third, the scope of the negligence penalty could be expanded to cover other taxes imposed by the Code, such as the estate tax and additional excise taxes. Fourth, a new penalty could be added that would apply to reckless or intentional behavior. This new penalty could apply to behavior that is more than merely negligent but that is not fraudulent. Fifth, it might be possible to apply the negligence penalty, and perhaps the fraud penalty as well, uniformly to all taxpayers, regardless of whether they relied upon counsel. Alternatively, the existing penalties for negligence or fraud by return preparers or the existing penalties for understating tax liabilities could be strengthened.

Analysis

In general

Because the negligence and fraud penalties are not being applied in a large number of cases where their application is fully justified, it may be appropriate to emphasize their proper application by

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[15] *United States* v. *Boyle*, U.S., 105 S.Ct. 687 (January 9, 1985).

[16] *See*, for example, "Deficit Reduction Act of 1984," Conference Report (H. Rep. No. 98-861; June 23, 1984), pp. 985-986; Conference Report on Repeal of Contemporaneous Recordkeeping Requirements (H. Rep. No. 99-67; May 7, 1985), pp. 13-14.

reenacting these penalties [17] or modifying them in ways that improve their efficacy.

Apply penalties only to understatement attributable to negligence or fraud

Some argue that it is inappropriate to apply the negligence and fraud penalties to the entire amount of the underpayment, once negligence or fraud has been determined. For example, if one taxpayer has underpaid $2,000 in taxes, of which $500 is attributable to negligence, and another has underpaid $2,000 in taxes, the entire amount of which is attributable to negligence, the 5 percent component of the negligence penalty would be the same for both taxpayers. Some would consider the imposition of the same penalty in these two situations to be both unfair and an insufficient deterrent to negligent behavior.

On the other hand, others argue that it is administratively simpler for the IRS to apply the penalty to the entire amount of the understatement, once negligence or fraud has been determined. This argument may, however, have less significance now than it did in the past because the second, time-sensitive component of these penalties applies under present law only to the portion of the understatement attributable to negligence or fraud. Consequently, if it is administratively feasible to apply the penalty under present law only to the portion attributable to negligence or fraud, then it would be administratively feasible to apply the entire penalty only to the portion of the understatement attributable to negligence or fraud.

If these penalties were modified to apply only to the portion of the understatement attributable to negligence or fraud, it may be appropriate to raise the percentage level of these penalties to compensate for narrowing their scope.

Special negligence penalty

Some argue that the scope of the current special negligence penalty that applies to failures to include in income interest or dividends reported on an information return is too narrow. The theory behind the current penalty is that a taxpayer who receives an information report on interest and dividends has been clearly notified of this income; consequently, absent clear and convincing evidence, that taxpayer should be penalized for failure to report these amounts.

Critics of the narrow scope of the current penalty argue that, while this rule is appropriate, it is anomolous to apply it only to interest and dividends. They note that a number of other types of payments are reported on information returns, and they argue that any payment reported on an information return should be subject to this penalty. Others note that it may be inappropriate to expand this penalty to some types of information reporting, such as reporting on mortgage interest paid by the taxpayer. Because this information reporting relates to a deduction rather than an income

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[17] For example, Congress reenacted the information reporting requirement for brokers (sec. 6045) as part of TEFRA to indicate its importance. Congress also mandated that the IRS implement that provision.

item, it may be more difficult to apply the special negligence penalty to these information reports.

Taxes included in scope of negligence penalty

Some argue that applying the negligence penalty only to negligent behavior with respect to income taxes, gift taxes, and the windfall profit tax, is too restrictive. They argue that the negligence penalty should apply to all taxes imposed by the Code, as does the current fraud penalty. Thus, for example, the scope of the negligence penalty could be expanded to include the estate tax and excise taxes (in addition to the windfall profits tax).

New penalty for reckless or intentional behavior

Some argue that one of the problems with the current negligence penalty is that it applies to a wide range of behavior. While the penalty may be appropriate for true negligence, which is often associated with careless behavior, it may be too small to deter reckless or intentional behavior, which may be considered to be more willful. The reckless or intentional behavior may not, however, rise to the level of fraud, so that the negligence penalty is the only penalty applicable under present law. This is true because the current penalty applies both to negligence and to intentional disregard of rules or regulations.

Consequently, it may be appropriate to add a new penalty for reckless or intentional behavior and to remove intentional disregard of rules and regulations from the present negligence penalty. An example of reckless or intentional behavior might be maintaining records that are required, but taking a position on a tax return far in excess of that supported by the records.[18] Since the behavior to which this new penalty would apply is between negligence and fraud, it might be appropriate to establish the level of this new penalty at a level between the 5 percent for negligence and the 50 percent for fraud.

Reliance on counsel

Some argue that it is inappropriate and unfair to waive the negligence and fraud penalties when the taxpayer relied on competent tax counsel, whereas the penalty is not waived when another taxpayer engages in identical behavior, but without the benefit of counsel. Those taking this position hold to the theory that these penalties are designed to penalize specific behavior in filling out a tax return, regardless of the intent of the taxpayer whose return it is. Under this theory, the penalty is to apply to negligence in filling out the tax return, regardless of whether the taxpayer himself or the taxpayer's attorney was negligent. Others argue that the penalty is to apply only to the taxpayer's intent, and reliance on counsel

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[18] For example, in one case, the taxpayer kept a "diary" of travel expenses recording, among other things, hotel expenses for days his testimony indicated he stayed in a personal residence. The court concluded that on the facts, both the taxpayer and his accountant "knew or should have known that these costs were personal expenses. . . . Because such items were deducted so frequently and were so large, we believe to claim them as deductions . . . amounted to intentional disregard for the rules and regulations."

In another case, the taxpayer was employed as a salesman. He deducted substantial business expenses but failed to report gross income admittedly received. The court concluded that the omission "had to be intentional and had to be in total disregard of the regulations."

is important in establishing the intent of the taxpayer. Those taking this position hold to the theory that these penalties are designed to penalize the intent of taxpayers, not just their behavior. They also note that it may be unfair to impose a penalty on a taxpayer for the behavior of another person (the attorney). The taxpayer could, however, sue the attorney for malpractice if the taxpayer is penalized for the attorney's behavior.

In current practice, the negligence and fraud penalties penalize both behavior and intent. To the extent that these penalties are modified to penalize behavior with respect to the tax return (regardless of whether the taxpayer or the taxpayer's counsel filled out the return) and to minimize the role of the taxpayer's intent, consideration might be given as to whether it is appropriate to retain the waiver of these penalties for taxpayers who relied on counsel. On the other hand, it may be difficult or undesirable to minimize the role of the taxpayer's intent for the fraud penalty; intent can be viewed as a significant element in determining fraud, or perhaps as an element in the definition of fraud. Consequently, it may not be appropriate to modify the present practice of waiving the fraud penalty for taxpayers who relied on competent counsel.

An alternative to modifying the present practice of waiving the negligence and fraud penalties for taxpayers who reasonably relied on competent counsel would be to modify the tax return preparer's penalties and make them more parallel, in both scope and amount, to the fraud and negligence penalties. This would penalize negligent or fraudulent behavior of a return preparer in the same manner that the same behavior by the taxpayer would be penalized. Consideration might also be given to expanding the scope of the penalties that do not turn on intent, such as the penalty for substantial understatement of tax liability (sec. 6661).

2. Penalties Relating to Information Returns

Background and Present Law

The Code requires that information returns be filed with the IRS, and a copy given to the taxpayer, detailing all wages, most other types of income, and some deductions. These requirements apply to a variety of specific payments, and are described in a number of Code provisions.

The Code also provides civil penalties for failure either to file an information return with the IRS (sec. 6652) or to provide a copy to the taxpayer (sec. 6678). These penalty requirements generally track the specific information reporting requirement to which they are related. Additionally, the general penalty for failure to supply an information return to the IRS is separate from the penalty for failure to give a copy to the taxpayer. Consequently, there are a number of these penalty provision in the Code. Generally, these penalties are $50 for each failure; some penalty provisions provide that the maximum penalty is $50,000 per year.

The Code also provides a $5 penalty for failure to furnish a correct taxpayer identification number (for individuals, the social security number) (sec. 6676). The Code does not provide a penalty for including incorrect information on an information return.

Proposals

Administration proposal

The Administration proposal would provide a new penalty for furnishing incorrect information to the IRS or a taxpayer; the penalty would be $5 for each incorrect document. The Administration proposal also would consolidate the general penalty for failure to give a copy of an information return to the taxpayer with the general penalty for failure to supply an information return to the IRS. The Administration proposal would eliminate the $50,000 maximum on these information returns penalty provisions. These proposals would be effective on January 1, 1986.

1984 Treasury report

The 1984 Treasury report also proposed both a new penalty for furnishing incorrect information and consolidation of the general penalty for failure to give a copy of an information return to the taxpayer with the general penalty for failure to supply an information return to the IRS. The Treasury report, however, proposed generally higher monetary penalties.[19]

Analysis

Modification of structure of penalties

Simplifying these penalties, consolidating them, and making them more comprehensible may promote compliance, in that taxpayers will be able to understand more easily the consequences of non-compliance. To the extent, however, that the complexity of the current penalties reflects the complexity of the current reporting provisions, it may be difficult to simplify the penalty provisions without first examining the underlying reporting provisions.

Eliminate cap on penalties

The current maximum penalty operates so as to impose the same penalty on a person who fails to file 50,000 information returns as on a person who fails to file 1,000 information reports. This disproportionality may be viewed as unfair. On the other hand, however, absent the cap a failure to file a very large number of information returns may result in a penalty much larger than the level of many monetary penalties for non-tax Federal offenses.

As an alternative to eliminating the cap, it would be possible to raise the cap. For example, it might be possible to provide that the maximum penalty is $500,000. Alternatively, it might be possible to provide a cap that is a specified percentage of the gross amount required to be shown on the information returns not properly filed. This approach might make the maximum penalty more proportionate to the harm that the failure to report has caused.

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[19] The Treasury report proposed that the penalty for failure to file an information return with the IRS be the lesser of $1,000 or 10 percent of the gross proceeds required to be reported. The penalty for failure to give a copy of an information return to the taxpayer would be maintained at $50. A new penalty for failure to furnish or provide data would be $50. The penalty for failure to supply information would be $10, while the penalty for supplying information that is incorrect is $50. All these penalties would be increased if the failure was due to intentional disregard of these filing requirements.

3. Penalty for Failure to Pay Taxes

Background and Present Law

The Code provides that a taxpayer who fails to pay taxes when due must pay a penalty (sec. 6651(a)(2) and (3)). The penalty applies to a taxpayer who fails to pay taxes shown on the tax return. It also applies to a taxpayer who fails to pay taxes not shown on the tax return within 10 days of notice and demand for payment by the IRS. The penalty is one-half of one percent of the tax for the first month not paid, and increases by one-half of one percent for each month the failure to pay continues, up to a maximum of 25 percent.

This penalty can be abated if the failure is due to reasonable cause and not willful neglect. This penalty is not deductible for tax purposes. The IRS estimates that the penalty for failure to pay taxes brings in approximately two-thirds of the total cost of collecting delinquent taxes.

Administration Proposal

The Administration proposal would replace the penalty for failure to pay taxes with a cost of collection charge. This charge would be established at a level to recover IRS' costs of collecting delinquent payments.

Analysis

Replacing the current penalty with charges for the cost of collection means that taxpayers would pay increased charges the longer they delayed paying back taxes. This would happen because the earlier stages of the collection process employ relatively inexpensive measures, while the later stages of the collection process employ much more expensive, labor-intensive measures. Because this proposed system would more closely reflect the actual costs incurred by the IRS in collecting past due amounts, this change might be viewed as resembling a user's fee. The current penalty is designed instead to be a deterrent to undesired behavior. It can be argued that replacing the current penalty with an escalating scale of charges for the cost of collection might therefore encourage taxpayers to pay more promptly.

It appears that the intent of the Administration proposal is to have Congress legislatively establish this new cost of collection charge. If instead the Administration were to propose that Congress permit the IRS to establish administratively the cost of collection charge, some taxpayers might criticize the charge because they would view the IRS as having no incentive to minimize collections costs, in that those costs will be reflected in the proposed charges. Since amounts recovered from this cost of collection charge would go into general revenues, instead of a fund designated to support IRS collection operations, this criticism may reflect a perceptual problem more than an actual danger.

One way of accomplishing the objectives of the Administration proposal that is under consideration by the IRS is to retain the current structure of the failure to pay penalty, but to increase the

amount of the penalty to one percent per month (from one-half percent per month) at approximately the time the delinquent account is sent to an IRS field office for collection. Thus, the penalty would generally start at one-half percent per month, and would increase to one percent per month at approximately the time that more expensive collection techniques must be employed because the taxpayer has not yet paid the delinquent amounts. When an account is sent to a field office, the IRS generally switches collection methods, from correspondence (which is relatively less costly), to telephone calls or personal visits (which are relatively more costly). Thus, increasing this penalty at that point in time would reflect the fact that IRS' costs of collection increase significantly the longer the taxpayer delays paying the delinquent taxes.

4. Penalty for Overstatement of Pension Liabilities

Background and Present Law

The Code provides a penalty for certain valuation overstatements, such as an overstatement of the value of an item for which a charitable deduction is claimed (sec. 6659). The amount of the penalty is a specified percentage of the underpayment of income tax attributable to the valuation overstatement. That percentage is 10, 20, or 30 percent, depending on the degree of overstatement of the value or basis of property and on whether the overstatement occurred with respect to a charitable deduction. A similar penalty applies to underpayments of estate or gift taxes attributable to valuation understatements (sec. 6660). Neither penalty applies if the underpayment is less than $1,000. The IRS has authority to waive the penalty if the taxpayer shows a reasonable ground for the claimed valuation or basis.

Possible Proposal

Penalties could be provided that would apply to certain overstatements of liabilities under defined benefit pension plans.

Analysis

Those who support the proposal point out that, in some instances, deductions for employer contributions to defined benefit pension plans have been based on abusive overstatements of the liabilities under the plans. For example, cases have been found in which the liability of a plan to provide benefits with respect to unmarried professionals, who were the sole owners and employees of their professional corporations, were overstated through the use of extreme actuarial assumptions. A pattern was found in which a corporation's deductions were based on the assumptions that (1) the professional employee will be married when benefits commence, (2) the spouse will be considerably younger than the employee (20 years in one case), (3) the spouse will outlive the employee, and (4) the plan will provide survivor benefits to the surviving spouse for an extended period. They also point to cases in which plans enjoying investment yield in excess of 9 percent are computing deductions on the basis of a 5 percent investment yield (larger contributions are required under a plan that earns a lower yield).

Opponents of this proposal argue that present law imposes adequate sanctions if deductions are found to be based on overstatements of liabilities. The sanctions include (1) disqualification of the plan, (2) disallowance of the excessive deductions, and (3) disenrollment or suspension of the enrolled actuary involved.

Those favoring the proposal point out, however, that the present law sanctions may not effectively deter an actuary from overstating liabilities. Because disqualification of a plan may injure other employees, that sanction is rarely applied. They also noted that, although three resignations have been accepted, the disenrollment sanction has never been imposed since it was first provided by ERISA in 1974.

In addition, they question the effectiveness of the deduction sanction. They note that, even if excessive deductions are disallowed, certain deduction carryovers are permitted. Thus, even if deductions are deferred, they are not lost. In addition, because earnings on excess contributions are not taxed until withdrawn, some argue that limits should be imposed on the ability of employers to make nondeductible contributions to a qualified plan.

Opponents also note that the imposition of sanctions must be based on the reasonableness of the valuation of liabilities as of the time the valuation is made. This is necessarily based on actuarial assumptions which are estimates of future experience. Opponents point out that actuaries must make assumptions with respect to the future and that two actuaries acting in good faith may differ widely as to projected costs under a plan. Under these circumstances, they argue, it would be unfair to impose sanctions based on hindsight, even if the IRS were to be given the authority to waive the penalty if the taxpayer established a reasonable basis for the assumptions. In addition, some argue that it is not possible to prove currently that an actuary's assumptions as to the future are unreasonable.

C. Interest Provisions

Background and Present Law

Taxpayers must pay interest to the Treasury on underpayments of tax (Code sec. 6601). Interest generally accrues from the due date of the tax return (determined without regard to extensions). The Treasury must pay interest to taxpayers on overpayments of tax (sec. 6611). Both the rate taxpayers pay to the Treasury and the rate the Treasury pays to taxpayers are the same rate (sec. 6621). That rate is determined semi-annually for the six-month period ending on September 30 and March 31. The adjusted rate takes effect on the following January 1 (for September 30 determinations) and July 1 (for March 31 determinations). The rate utilized is the prime rate quoted by large commercial banks as determined by the Board of Governors of the Federal Reserve System. A special rate of 120 percent of the general rate applies to taxpayers who make substantial underpayments of tax attributable to tax-motivated transactions, such as tax shelters.

Interest that taxpayers pay to the Treasury is deductible.[20] Interest that the Treasury pays to taxpayers is includible in gross income.

Possible Proposals

It would be possible either to raise the interest rate that taxpayers pay the Treasury or to lower the interest rate that the Treasury pays to taxpayers, or both. It would also be possible to alter the mechanics of computing the interest rate, so that it is more reflective of current market rates. It would be possible to eliminate the deductibility of interest paid on delinquent taxes. Finally, it would be possible to charge interest on underpayments of the accumulated earnings tax.

Analysis

Few financial institutions, commercial operations, or other entities, borrow and lend money at the same rate.

Rate paid by Treasury

Some argue that the rate paid by the Treasury to taxpayers is generally too high, compared to rates that taxpayers can obtain from other sources. The prime rate is generally higher than other rates of interest being paid by the Federal Government; for example, it is currently significantly higher than the rate being paid on 3-month and 6-month Treasury bills. Because the taxpayer suffers no risk that the interest will not be paid due to a lack of creditworthiness of the borrower (the Federal Government), it might be argued that the Treasury should pay no higher rate of interest on overpayments of taxes than it does in other instances when it borrows money from taxpayers.

Because the rate of interest paid by the Treasury on overpayments of tax is generally higher than other rates being paid by entities with comparable creditworthiness, taxpayers may have an incentive to overpay their taxes to obtain these higher rates. There is some concern that a few large taxpayers may have arranged their affairs so that they could take advantage of the 13-percent rate being paid on overpayments from January 1 through June 30, 1985.

Rate paid by taxpayers

It might also be argued that the rate of interest that taxpayers pay to the Treasury on underpayments and nonpayments of tax may be too low. Few taxpayers are able to borrow money at the prime rate; this is particularly true of individuals. Consequently, it might be beneficial to raise the rate taxpayers pay to the Treasury to a rate more reflective of actual rates in an appropriate market. Some might argue that it would be beneficial to raise the rate beyond this level, which could provide a disincentive for taxpayers to delay payment of taxes.

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[20] This interest presumably would be subject to the general limitations on the deductibility of non-business interest proposed by the Administration. This proposal is discussed in a forthcoming pamphlet on taxation of individuals.

On the other hand, however, it might be argued that in general the greater the risk of not being repaid, the higher the rate of interest charged. Because the Internal Revenue Service has many enforcement mechanisms available to it that are designed to assist in the collection of taxes owing, such as filing liens, levying on assets, or the seizure of property,[21] the risk of taxes not being ultimately paid may be lessened. A counterargument to that would be that requiring taxpayers to pay a higher rate of interest, more reflective of market rates, would encourage taxpayers to pay their taxes promptly. A higher rate might discourage taxpayers from delaying payment of taxes. Taxpayers may currently be delaying payment of taxes because they may be able to borrow money at a lower rate from the Federal Government than elsewhere; consequently, it is worthwhile for them to retain the use of the tax payments for as long a period as possible.

Mechanics of computing rate

In the last two decades, there have been substantial and relatively rapid fluctuations in interest rates in the economy. Although the interest rate in the Code is currently determined every six months, that rate reflects actual rates that were paid from 3 to 15 months previously. For example, the 13-percent rate in effect for January 1 through June 30, 1985, was determined by examining prime rates during the period from April 1 through September 30, 1984. Generally, interest rates have declined since that period.

The method of determining the interest rate under the Code may result in an interest rate that is not reflective of current market rates, particularly in a period of general volatility of interest rates. This may consequently affect taxpayers' economic calculations regarding when it is most beneficial to pay the tax due.

Several methods might be considered that would make the determination of the interest rate under the Code more reflective of current market rates. First, it would be possible to shorten the 6-month base period over which interest rates are considered; for example, basing the rate under the Code on rates in effect for a one-month period might be appropriate. Second, it would be possible to reduce the lead time between the determination of the interest rate and the date it becomes effective; currently, the lead time is two and one-half months. Third, it would be possible to adjust the interest rate more frequently than twice a year. While more frequent adjustment might present administrative difficulties with respect to relatively small amounts, providing for more frequent adjustments for large amounts would generally be reflective of commercial practice.[22]

For example, it might be possible to alter this interest rate determination procedure so that it more closely resembles the statutory mechanism for determining the Federal rates, which are used to test the adequacy of interest in certain debt instruments issued for

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[21] In 1984, 846 notices of liens were filed, 1,484 notices of levy were served on third parties, and 20 seizures of property were made.

[22] One apparent reason for the current structure of the interest provisions of the Code is that it was difficult in the past for taxpayers and the IRS to make relatively complex interest calculations. Because of recent technological advances in and the widespread availability of sophisticated calculators, this concern may not be as relevant at the present time.

property and certain other obligations. The Federal rates are redetermined on a monthly basis by Treasury. They are based on the average yield of specified Federal securities for the one-month period ending on the 14th day of the month preceding the month they become effective.

Deductibility of interest paid by taxpayers

Some argue that interest paid by taxpayers to the Treasury on underpayments and nonpayments of taxes should not be deductible. They argue that making this interest deductible means that the Treasury does not receive the true rate of interest and that other taxpayers subsidize the late payment of taxes by taxpayers who owe interest. For example, if the interest rate is 13 percent, taxpayers in the 50-percent bracket who deduct this interest on their tax returns pay an effective interest rate of 6.5 percent.

On the other hand, however, it could be argued that a taxpayer can borrow the money to pay these taxes from a financial institution rather than from the Treasury. This taxpayer would thus be able to deduct the interest payments on this loan. This taxpayer would, by borrowing from a financial institution, be able effectively to circumvent the prohibition on deducting interest paid on taxes.

Proponents of the prohibition on deducting interest on taxes note that a taxpayer borrowing from a financial institution under these circumstances is unlikely to be required to pay as favorable a rate as the prime rate as currently determined; consequently, even a taxpayer in the 50-percent bracket will pay an effective rate higher than half the prime rate.

Interest on underpayments of accumulated earnings tax

It would be possible to charge interest on underpayments of the accumulated earnings tax. This tax (sec. 551) is imposed to prevent corporations from accumulating (rather than distributing) dividends with the intent of reducing or avoiding taxes. Interest is charged under present law only from the date the IRS demands payment of the tax, rather than the date the return was originally due to be filed.

D. Estimated Tax Payments by Individuals

Background and Present Law

Individuals owing tax who do not make estimated tax payments are generally subject to a penalty (Code sec. 6654). In order to avoid the penalty, individuals must make quarterly estimated tax payments that equal at least the lesser of 100 percent of last year's tax liability or 80 percent of the current year's tax liability. Amounts withheld from wages are considered to be estimated tax payments.

The provisions relating to estimated tax payments by individuals were extensively modified and simplified in the Tax Reform Act of 1984. The 1984 Act did not, however, alter either the 100-percent rule or the 80-percent rule.

Proposal

It would be possible to increase either the percentage of the current year's tax liability or the percentage of the previous year's tax liability, or both, that taxpayers are required to pay to avoid imposition of the estimated tax penalty. S. 409 and H.R. 800 (the Bradley-Gephardt bill) would increase to 90 percent (from 80 percent) the percentage of the previous year's tax liability required to be paid by an individual with an adjusted gross income exceeding $100,000 to avoid an estimated tax penalty.

Analysis

Taxpayers whose sole (or primary) form of income is wages generally do not make quarterly estimated tax payments, because they generally have sufficient taxes withheld from their wages to cover their tax liability. In fact, many of these individuals have taxes withheld from their wages in excess of their ultimate tax liability. Taxpayers who make quarterly estimated tax payments generally receive a significant amount of income from non-wage sources.

Some argue that it would be appropriate to raise the minimum amount of estimated taxes that must be paid in order to avoid the penalty so that the amount paid more closely approximates the actual tax liability that the taxpayer will owe. Those opposed to making any change note that the estimated tax provisions were extensively considered and revised as part of the 1984 Act, and that it is therefore inappropriate to adjust these provisions so soon after they have been extensively revised.

One alternative would be to raise the percentage of the previous year's tax liability that must be paid in order to avoid the estimated tax penalty. For example, it would be possible to raise this percentage from 100 percent to 120 percent. Taxpayers who base their estimated tax payments on the previous year's tax liability generally know that their tax liability for the current year will exceed that for the previous year.[23] Thus, these taxpayers may pay less in estimated taxes than their tax liability ultimately will be. Those opposed to this proposal argue that not everyone basing their estimated tax payments on their previous year's liability has increased income in the current year; they simply may be uncertain as to their income in the current year and prefer to base their estimated taxes on a known amount.

Another alternative would be to raise the percentage of the current year's tax liability that must be paid in order to avoid the estimated tax penalty. For example, this percentage could be raised from 80 percent to 90 percent. This would cause the estimated tax payments made to approximate more closely the taxpayer's actual tax liability as is the case for the vast majority of wage earners. Those opposed to this alternative note that some who utilize this rule have incomes that fluctuate significantly. Thus, these taxpayers may deposit more than 80 percent of their current year's liability in order to be certain not to be penalized. Consequently, raising

[23] If they know that their current year's liability will be less than or equal to the previous year's tax liability, they will base their estimated tax payments on their current year's liability.

this percentage may cause taxpayers to pay more in estimated taxes than their ultimate tax liability will be.

Finally, it would also be possible to raise both (rather than only one or the other of) the percentage of the previous year's tax liability and the percentage of the current year's tax liability that must be paid, to avoid the estimated tax penalty. Alternatively, both (or either) of these limits could be raised only for certain individuals, such as those with high incomes.

E. Return-Free System

Background and Present Law

Individuals whose income exceeds specified levels must file income tax returns each year. Generally, these returns must be filed by April 15, unless the taxpayer receives an extension of time to file.

Information reports are prepared on wages, many other income items (such as interest and dividends), and some deductions (such as mortgage interest). These reports are generally required to be furnished to the taxpayer by January 31; the copy for the Internal Revenue Service (IRS) generally must be furnished by the last day of February. The copy for the IRS generally is furnished on magnetic media (see Code sec. 6011(e)).[24]

Administration Proposal

The Administration proposes that the IRS be given authority to implement a return-free system for individuals. Taxpayers who meet certain criteria (relating to the complexity of their returns) would be offered the option of not filing an income tax return. Instead, the IRS would prepare the return and compute the tax liability of the taxpayer. The IRS would do this using wage reports currently filed with the Social Security Administration and information returns currently filed with the IRS. The IRS would send the taxpayer a report stating the Service's calculation of the taxpayer's tax liability. The taxpayer would be free to challenge the Service's calculation of tax.

Analysis

Interaction of tax reform and the return-free system

It would be possible to implement a return-free system under the present Internal Revenue Code. To the extent the Code is simplified by eliminating deductions and credits, a greater percentage of taxpayers would be able to participate in the return-free system. The costs of implementing the return-free system are generally the costs of additional computer capacity and programming. Thus, these costs would generally be fixed, regardless of the percentage of taxpayers who could participate. Consequently, the return-free system

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[24] For the 1983 taxable year, the IRS received approximately 85 percent of non-wage information returns on magnetic media; the remaining 15 percent of information returns were filed on paper. Wage information is furnished to the Social Security Administration, which compiles the information and forwards it to the IRS. Approximately one-third of all wage information is given to Social Security on magnetic media.

would be more cost-effective if more taxpayers could participate. As a result, it may not be advantageous to implement the return-free system unless a certain minimum percentage of taxpayers are eligible to participate.

Taxpayers eligible to participate

In general, the simpler the taxpayer's return, the more easily that taxpayer could participate in the return-free system. Under the present Internal Revenue Code, taxpayers who file Form 1040EZ, the simplest form, would generally be able to participate. Taxpayers filing this form and claiming the charitable deduction for non-itemizers, however, could not participate. Additionally, many taxpayers who file Form 1040A would be able to participate. Taxpayers filing this form and claiming the child care credit or the credit for political contributions (or the charitable deduction for non-itemizers) could not participate.

Many taxpayers filing Form 1040 would not be able to participate, particularly if they used, for example, Schedule A (Itemized deductions), Schedule C (Profit or loss from a business or profession), or Schedule F (Farm income and expenses). A taxpayer who filed Form 1040 solely because interest or dividends exceeded $400 would, however, be able to participate in the return-free system. For tax year 1983, 16.0 million Forms 1040EZ were filed, 19.6 million Forms 1040A were filed, and 60.9 million Forms 1040 were filed.

The return-free system would be available only for individuals. Other taxpayers, such as corporations, estates, and trusts, would not be able to participate because the information reporting sources available to the IRS are not sufficiently comprehensive to inform the IRS of the information on most lines of those returns.

Administrative issues

For the return-free system to be acceptable to taxpayers, the IRS generally would need to inform taxpayers of their tax liability by April 15, and pay the refunds due soon thereafter. To accomplish this, the IRS would need to process information returns and the Social Security Administration would need to process wage reports early in the calendar year. This would be significantly earlier in the year than these reports are currently processed.

The IRS generally would need to process every information return and the Social Security Administration would need to process every wage report early in the calendar year, despite the fact that not all taxpayers would be eligible to participate in the return-free system. Every report would need to be processed before the IRS was certain that it had all the information necessary to implement the return-free system for those taxpayers participating, even though this would mean that reports relating to taxpayers not participating in the return-free system would be processed more rapidly than might be otherwise necessary.[25] This processing

[25] More rapid processing of this information could also facilitate the examination and audit of returns not under the return-free system. This could be an ancillary compliance benefit of the return-free system.

would need to be done at the same time that the IRS is receiving and processing tax returns from taxpayers not participating in the return-free system. It would appear that the IRS and the Social Security Administration would need significant additional computer capacity in order to implement the return-free system. Because of the rapidity with which this information would need to be processed, it might be desirable or necessary for IRS to process wage reports and compile the information for Social Security, rather than the reverse, which occurs presently.

Although the Administration proposal does not discuss the effect of the return-free system on the current penalty structure and statute of limitations in the Code, it may be necessary to reexamine the applicability of these provisions to taxpayers utilizing the return-free system.

F. Tax Amnesty

Background and Present Law

The Federal Government has never instituted a program that provided amnesty from both civil and criminal penalties for taxpayers who both voluntarily disclosed that they had underpaid their taxes and then paid those amounts.

The IRS had an administrative policy, discontinued in 1952,[26] that in effect provided amnesty from criminal prosecution (but not from civil penalties or interest) for taxpayers who voluntarily disclosed that they had underpaid their taxes. In 1961, the IRS issued a news release suggesting to taxpayers that, since the IRS was then installing new data processing equipment, it might be a propitious time for taxpayers to disclose voluntarily any underpayments of tax. The news release also noted that the likelihood of criminal prosecution was not high in instances of voluntary disclosure, although the news release offered no assurances that amnesty from criminal prosecution would be granted. A current policy statement of the IRS includes voluntary disclosure of tax underpayments as one criterion to be considered in determining whether a case warrants criminal prosecution.

A number of States have recently instituted tax amnesty programs.[27] These programs differed widely as to the types of taxes included, whether criminal penalties only or civil penalties as well were waived, whether interest was required to be paid, and whether increased penalties and other compliance measures were instituted following the amnesty period.[28]

Proposals

The Administration proposal did not discuss tax amnesty. The 1984 Treasury report stated, however, that "the Treasury Depart-

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[26] It appears that this policy was officially terminated because of failure to pay the taxes once amnesty had been granted, increased litigation, and lack of uniformity in administering the program.

[27] These States are: Alabama, Arizona, California, Idaho, Illinois (two programs), Kansas, Massachusetts, Minnesota, Missouri, North Dakota, Oklahoma, and Texas.

[28] For a more complete survey of State and foreign amnesty programs, see: Internal Revenue Service, *Study of Recent Tax Amnesty Programs* (May 1985 draft); Library of Congress, Congressional Research Service, *Tax Amnesty: State and European Experience* (April 13, 1984).

ment rejects" amnesty.[29] Treasury rejected any form of tax amnesty, whether it is restricted only to amnesty from criminal penalties or whether amnesty also extends to civil penalties, interest, and past taxes due. The Treasury report rejected amnesty because of its negative effect on "taxpayer morale." The Treasury report also stated that amnesty "can only reinforce the growing impression that the tax system is unfair and encourage taxpayer non-compliance." [30]

Several bills that would provide a Federal tax amnesty have been introduced in the current session of Congress.[31] These bills generally would provide amnesty from civil and criminal penalties; the bills differ as to whether amnesty would be provided for all or a portion of the interest due on the back taxes. All would require payment of the back taxes.

Analysis

Types of amnesty

There are several types of tax amnesty programs. The broadest form of amnesty would forgive all past taxes, interest, and civil and criminal penalties. The goal of this type of amnesty is not to collect taxes owing from prior years, but to place on the tax rolls for the future those who previously had escaped taxation.

A narrower form of amnesty would require taxpayers to pay past taxes, but would forgive all (or a portion of) the interest due on those taxes. In addition, all civil and criminal penalties would be forgiven. The goal of this form of amnesty (as well as the variants of it described below) is both to collect taxes owing from prior years and to place on the tax rolls those who had previously escaped taxation.

Proponents of this form of amnesty generally view charging interest on past due taxes as a penalty. Others generally view these interest provisions as reflecting the time value of money. Thus, absent these interest provisions, a taxpayer would prefer to delay paying taxes for as long as possible so as to retain the use of the money for as long as possible.[32]

An even narrower form of amnesty would require taxpayers to pay all taxes and interest due, but would forgive all civil and criminal penalties. The narrowest form of amnesty would require taxpayers to pay all taxes, interest, and civil penalties, but would forgive criminal penalties.

Most of the amnesty programs operated by the States forgive both civil and criminal penalties; these programs differed as to whether all or a portion of the interest due was forgiven. All have required payment of the past taxes.

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[29] Treasury Report, Vol. 1, p. 91.

[30] *Ibid.*

[31] S. 203 (Senator Dixon); H.R. 2031 (Mr. Biaggi); H.R. 2530 (Mr. Donnelly). For a description of S. 203, see Joint Committee on Taxation, *Description of S. 203 (Relating to Tax Amnesty)*...(JCS-22-85), June 21, 1985.

[32] Congress has in the past conformed these interest provisions more closely to market conditions to minimize any incentive taxpayers might have to delay paying taxes past the due date.

Authorization of amnesty

Any type of amnesty, except amnesty from criminal penalties only, would require legislative authorization. The Code requires the payment of all taxes owing. The Code also requires that interest be paid. The Code gives the IRS some administrative flexibility in determining whether to assess some civil penalties; however, a number of civil penalties are assessed relatively automatically. The greatest flexibility exists in the imposition of criminal penalties.

Some State amnesty program were mandated or authorized by the State legislatures; others were established administratively by the State revenue department.

Frequency of amnesty

Most advocates of a Federal tax amnesty propose that the program be offered only once and suggest that it be made clear that amnesty will not be offered again. Opponents of amnesty are concerned that, once a Federal tax amnesty is offered, the public will expect it to be offered again, despite official announcements to the contrary. Opponents are concerned that this expectation of future amnesty programs may degrade current voluntary compliance.

Most States that have had tax amnesty programs have had them only once.[33] Many foreign countries that have amnesty programs either run them frequently or have continuous amnesty programs, which generally forgive a portion of the civil penalties and all criminal penalties for taxpayers who voluntarily disclose underpayments of tax.

Eligibility for amnesty

Amnesty programs can differ as to whether only nonfilers may participate, or whether individuals and entities that filed returns, but also either underreported income or overstated deductions or credits, may participate.

Amnesty programs can also differ as to the extent to which known tax evaders can participate in the amnesty. Individuals or entities under active criminal investigation or prosecution are generally not permitted to participate in amnesty. Amnesty programs differ as to whether individuals or entities under audit or administrative investigation are permitted to participate.

Arguments pro and con

Proponents of tax amnesty raise the following points in favor of their position. First, they argue that amnesty would raise a significant amount of revenue. Proponents have cited figures ranging from $7 to $15 billion to be raised from a Federal tax amnesty.[34] Second, they argue that amnesty would place on the tax rolls individuals and entities that previously had escaped taxation. Third, they argue that the proven success of tax amnesty in several

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[33] Illinois has had two amnesty programs. The first was administratively established, poorly advertised, and of short duration. The second was legislatively authorized, widely advertised, and of longer duration.

[34] *BNA Daily Tax Reporter*, June 6, 1985, p. G-1. Some have disputed the accuracy of these

States, such as Massachusetts and Illinois, demonstrates that amnesty should be utilized on the Federal level.

Opponents of tax amnesty raise the following arguments. The first is fairness. They argue that amnesty is inherently unfair, and would be widely perceived as unfair, to taxpayers who have fully paid their taxes for others who have not fully paid to escape punishment for, and profit from, their evasion. In addition, it may be unfair that a tax evader discovered by the IRS (or who voluntarily disclosed the evasion prior to the amnesty period) is fully subject to interest, civil penalties and criminal penalties, while a tax evader not discovered by the IRS may take advantage of the amnesty.

Another argument raised by opponents is that amnesty would not place large numbers of previously unknown individuals and entities on the tax rolls. They cite as support for this argument the low percentage of individuals and entities who took part in State amnesty programs who were previously unknown to the IRS.[35] They also note that tax evaders who have not yet been caught by the IRS may choose not to participate, in that they might expect that, since they have not yet been caught, there is little likelihood that they would be caught in the future, and that there is therefore little benefit to them in participating in amnesty.

Opponents of amnesty also argue that the State experience is neither uniformly positive nor a good predictor of success at the Federal level. They note that some States that have had an amnesty program have raised very little revenue.[36] Also, some States have encountered serious difficulties in administering their amnesty programs. They also note that State compliance efforts have not been as extensive as those of the IRS and that State penalties for noncompliance and evasion have not been as severe as those under the Code.[37] Finally, they express concern that continued discussion of Federal amnesty may have an adverse effect on current compliance, in that some taxpayers may be unwilling to comply or to disclose voluntarily non-compliance if they anticipate that a Federal amnesty might be offered. Thus, opponents believe that a Federal amnesty will not raise a significant amount of revenue, particularly over the long term, because they argue that amnesty will cause a degradation in, rather than an enhancement of, future voluntary compliance. Some believe that this degradation in compliance may in fact cause amnesty to lose revenue over the long term.

Proponents of amnesty respond to the opponents' fairness argument by noting that most taxpayers in States that have had successful amnesty programs have supported these programs. This support appears to be influenced by the amount of revenue garnered by these successful amnesty programs. Proponents also respond to the opponents' concern that amnesty will not place on the Federal tax rolls individuals and entities not previously known to

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[35] IRS has compiled data indicating that 6.11 percent of the total number of amnesty applicants in Alabama, Arizona, and Missouri were previously unknown to the IRS. Approximately one-half of these previously unknown amnesty applicants filed Federal returns for the first time for the year they participated in these State amnesty programs. Source: IRS, *Study of Recent Tax Amnesty Programs* (May 1985 draft), p. 2.

[36] Out of 13 total State amnesty programs, 6 raised less than $1 million; only 3 raised more than $15 million. Source: IRS, *Study of Recent Tax Amnesty Programs* (May 1985 draft), p. 8.

[37] For example, prior to its amnesty program, tax evasion was not a felony in Massachusetts.

the IRS by noting that the States administering amnesty programs have generally informed taxpayers who have participated in those programs that amnesty information will be shared with the IRS; this may discourage individuals and entities who have evaded both Federal and State taxes from participating in State amnesty programs, thus accounting for the low percentage of participants in State amnesty programs who were previously unknown to the IRS. They also note that tax evaders may have added incentive to participate if the compliance efforts of the IRS are strengthened at the same time that amnesty is offered.

G. Compliance Measures Related to Amnesty Proposals

Background

Many of the States that have instituted amnesty programs have concurrently instituted measures to increase compliance. These increased compliance measures are not necessarily linked to an amnesty program, and could be implemented without any accompanying amnesty program.[38]

1. Federal Contracts and Licenses

Present Law

The Code provides that the IRS may, upon written request, disclose whether an applicant for a Federal loan has a tax delinquent account (sec. 6103(l)(3)). The purpose of this provision is to prevent or reduce future loan delinquencies. The Code does not generally permit disclosure of tax information in connection with Federal contracts or license applications.

Proposals

Two bills introduced in this session of Congress [39] would provide that any taxpayer who is liable for past-due and unpaid taxes would be ineligible for any Federal contract or Federal license.[40]

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[38] Many amnesty proposals also would increase IRS staffing. This is discussed separately, in H., below.

[39] S. 1152 (Senator Kerry) and H.R. 2530 (Mr. Donnelly).

[40] The two bills would accomplish this goal in slightly different manners. S. 1152 would require persons applying initially for or renewing a Federal license, permit, or passport to attach a statement to the application certifying that all Federal and State taxes have been paid. Persons entering into Federal contracts worth $5,000 or more, as well as applicants for Federally provided, insured, or guaranteed credit or loans, must attach a similar statement to the contract or loan application. These certifications would be given to the IRS. If the certification is false, the bill would provide that the Federal agency is authorized to initiate the revocation of the license, to cancel the contract, to disqualify the person from further Federal contracts or loans, or to require immediate payment of the loan.

H.R. 2530 would provide that no Federal contract or subcontract may be awarded to any person who has a delinquent tax account. The bill would also provide that, in general, no Federal business license may be issued to any person who has a delinquent tax account. If a Federal business license has already been issued to a person with a delinquent tax account, the bill would provide that the license shall be revoked. Thus, the bill would provide that the Federal agency awarding the contract or issuing the license must determine from the IRS, before awarding the contract or issuing the license, that the person seeking the contract or license does not have a delinquent tax account.

One Federal program analogous to these proposals is the requirement that male applicants for Federal student loans certify that they have registered with the Military Selective Service.

Analysis

The theory behind this proposal is that a Federal contract or license is a privilege granted by the Federal Government, and that this privilege should not be extended to persons who have not complied with the tax laws.

One objection to this proposal is that it would place a burden on other Federal agencies that is not directly related to those agencies' missions. There are, however, several provisions in the Code that require the IRS to supply tax information to assist other Federal agencies with their programs.[41] On the other hand, others suggest that any burden resulting from verifying tax compliance of persons applying for Federal contracts or licenses that would be imposed on other Federal agencies is not different from the non-tax related burden already imposed on the IRS to assist these other agencies.

An additional objection to this proposal is that it further erodes the confidentiality of tax information. Proponents of permitting this disclosure suggest that the provision is not objectionable when assessed in light of the numerous exceptions to this confidentiality principle that have been enacted in recent years.[42]

2. Increase Tax Penalties

Present Law

The Code contains a number of penalties, both civil and criminal, for failure to file tax returns, failure to pay taxes due, and other specific acts or omissions that violate the tax law.

Proposal

Two bills introduced in this session of Congress[43] would increase all penalties in the Code, whether civil or criminal, by 50 percent.

Analysis

Proponents of an across-the-board increase in civil and criminal penalties argue that growing non-compliance with the tax laws indicates that taxpayers are not sufficiently deterred from non-compliance by the existing level of penalties. Also, they note that the level of many of these penalties has not increased in recent years. Consequently, the seriousness of some of these penalties has been eroded by inflation.

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[41] For example, tax information can be disclosed for purposes of determining eligibility for, or the correct amount of, benefits under aid to families with dependent children, Medicaid, supplemental security income benefits, unemployment compensation, and food stamps (see sec. 6103(*l*)(7) of the Code).

[42] This concern may be of less importance under H.R. 2530. That bill would provide for disclosure only of delinquent tax accounts. The measures that the IRS takes to collect these delinquent tax accounts may be quite public, such as seizure of property. Consequently, the level of confidentiality accorded delinquent accounts may not need to be as strict as that accorded other return information. Some States and several foreign countries, for example, publish lists of delinquent tax accounts.

[43] S. 203 (Senator Dixon) and S. 1152 (Senator Kerry). S. 203 includes a provision for tax amnesty; S. 1152 does not.

Opponents of an across-the-board increase in civil and criminal penalties note that some of these penalties were enacted in 1981, 1982, and 1984. They therefore argue that insufficient time has elapsed since enactment to assess their efficacy. Some opponents are also concerned that the level of civil and criminal penalties for tax violations may become disproportionate to the level of penalties for non-tax Federal offenses.

3. Publicity

Present Law

The Code provides that the IRS may disclose, upon approval of the Joint Committee on Taxation, tax information relating to a specific taxpayer to correct a misstatement of fact published or disclosed with respect to that taxpayer's tax return or dealings with the IRS, so long as disclosure is necessary for tax administration purposes (sec. 6103(k)(3)). This provision is rarely used.

Taxpayers' disputes with the IRS generally become public once a case is filed in court. Additionally, many of the collection actions taken by the IRS against delinquent taxpayers are conducted in public, such as seizures of property. Recently, the IRS has begun publishing in the Internal Revenue Bulletin a list of taxpayers enjoined from promoting abusive tax shelters or aiding understatements of tax liability.

Proposals

One bill introduced in this session of Congress[44] would authorize the IRS to disclose information to the media on certain delinquent taxpayers, such as those who have willfully failed to file tax returns or who are delinquent in paying over $10,000 in taxes, where the publicity would encourage others to comply with the tax laws. Another bill[45] would direct the IRS to publicize the risks and consequences of non-compliance with the tax laws. The bill would also direct the IRS to conduct seizures, when appropriate, of the property of taxpayers owing large amounts of tax so as to publicize the risks and consequences of non-compliance.

Analysis

Proponents of this type of publicity argue that it would increase awareness of the risks of tax evasion. They also argue that this type of publicity may increase the perception of fairness of the tax system, in that it would counteract the views of those who believe that higher income taxpayers can take advantage of the tax system in ways those individuals cannot. In addition, these proponents suggest that this type of publicity may foster the belief that tax evasion is not a victimless crime, which may in time decrease the social acceptability of evasion.

Opponents of this type of publicity are concerned about the disclosure of this type of tax information, which generally is considered private. In addition, they are concerned that disclosure of this

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[44] S. 1152 (Senator Kerry).
[45] H.R. 2530 (Mr. Donnelly).

type of tax information prior to the filing of a court case may be unfair to the taxpayer, in that the IRS may reconsider its position during the appeals process.

H. Audit Level and Number of IRS Personnel

Background and Present Law

The IRS is primarily responsible for activities that promote taxpayer compliance with the tax laws. These activities include matching information returns that the IRS receives from third parties (such as returns by banks reporting interest paid to the taxpayer) with the tax return of the taxpayer and auditing tax returns.

The percentage of income, estate, and gift tax returns that are audited has declined by 45 percent over the last 11 years.[46] The number of income tax returns filed (excluding estimated tax returns) increased by 17 percent over the last 11 years.[47] For those same 11 years, the number of IRS employees responsible for examining returns declined by 9 percent.[48] For 1973, the "tax gap," which is the difference between taxes voluntarily paid and correct tax liability, was estimated to be $28.8 billion. For 1981, the tax gap was estimated to be $81.5 billion.[49]

The Administration's budget proposal for fiscal year 1983 included a requested increase of 1,000 examination employees. Section 352 of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) contained a sense of the Congress resolution that additional funds be appropriated to provide for staffing levels beyond those proposed by the Administration so that additional tax revenues of $1 billion in fiscal year 1984 and and $2 billion in fiscal year 1985 would be collected.

In fiscal year 1985, IRS staffing actually increased by approximately 5,225 employees. Of this total, 1,000 were examination employees. Most of the remaining new employees were responsible for either collecting taxes already owing or for locating taxpayers who had not filed tax returns but who were required to do so. The Administration determined that all these new employees generated approximately $3 billion in increased revenue in 1983.

Administration Proposal

The Administration's budget proposal for fiscal year 1985 would freeze the IRS budget at 1984 levels. This would cause a decrease of approximately 1,250 IRS employees for fiscal year 1985.

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[46] The examination coverage of income, estate, and gift tax returns, expressed as a percentage of those returns filed, for each of the last 11 years, is as follows: 1974: 2.39 percent; 1975: 2.55 percent; 1976: 2.59 percent; 1977: 2.46 percent; 1978: 2.28 percent; 1979: 2.24 percent; 1980: 2.12 percent; 1981: 1.84 percent; 1982: 1.63 percent; 1983: 1.56 percent; 1984: 1.31 percent. Source: Annual Reports of the Commissioner or Internal Revenue.

[47] In 1974, 87,876,000 income tax returns (excluding declarations of estimated tax) were filed (see Commissioner's Report, 1975, p. 13). In 1984, 103,093,000 income tax returns (excluding declarations of estimated tax) were filed (see Commissioner's Report, 1984, p. 9).

[48] At the close of 1974, there were 27,898 employees in Audit (see Commissioner's Report, 1975, p. 147). At the close of 1984, there were 25,493 employees in Examination (see Commissioner's Report, 1984, p. 73). This function was renamed; there was no transfer of significant responsibilities from this function to another within the IRS that accounts for this decline.

[49] These numbers are for the legal sector only. Statistics are not available for either 1974 or 1984. Source: IRS Research Division, *Income Tax Compliance Research* (July 1983).

The Administration's budget proposal for fiscal year 1986 would increase the number of examination employees by 2,500 a year for fiscal years 1987, 1988, and 1989, resulting in an aggregate increase in examination employees of 7,500 by the end of fiscal year 1989. Advance hiring would begin in fiscal year 1986, which begins October 1, 1985.

Other Proposals

H.R. 3036 (Treasury fiscal year 1986 appropriations, as reported by the House Committee on Appropriations; H. Rep. No. 99–210, July 18, 1985) would increase the Administration's budget request for fiscal year 1986 by $177 million. These funds would be used primarily to increase computer capacity and hire new employees to process and examine tax returns.

Also, the House Committee on Ways and Means endorsed, on July 24, 1985, this increase in the IRS budget for fiscal year 1986.

Analysis

Some observers attribute the decline in voluntary compliance with the tax laws directly to the decline in the audit coverage. They argue that an audit has a beneficial compliance effect on the taxpayer audited, not only for the year being audited but for subsequent years as well. In addition, taxpayers who are audited will often discuss the audit with friends, neighbors, or business associates, thus raising the visibility of IRS enforcement functions generally.

Other observers note that, while audit coverage is declining, the IRS is increasing its contacts with taxpayers through other means. For example, the IRS has recently been increasing the percentage of information returns that it processes and matches with tax returns, and has consequently been increasing its contacts with taxpayers though correspondence that asks taxpayers to explain why, for example, an item of income reported to the IRS by a third party on a Form 1099 was not reported by the taxpayer on the taxpayer's tax return. Some have suggested, however, that taxpayer confidence in the correctness of IRS correspondence may decline due to the recent, well-publicized difficulties the IRS had in processing 1984 tax returns.

Increasing IRS audit coverage directly increases Federal revenues. At the current level of audit coverage, some observers have noted that, for each additional dollar spent on auditing activity, Federal revenues could increase by as much as eight dollars.[50] Thus, these observers argue that it is short-sighted to cut the audit coverage of the IRS since that directly decreases Federal revenues.

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[50] Source: Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (February 1985), p. 302.

I. Relationship of the Definitions of Wages for Income Tax Withholding and FICA

Background and Present Law

An employer must withhold income taxes from wages paid to an employee (Code sec. 3402). Wages are generally defined as all remuneration for services performed by an employee for an employer, including the cash value of all remuneration (including taxable fringe benefits) paid in any medium other than cash (sec. 3401). The Code lists a number of exceptions for specific types of remuneration; if, however, a type of remuneration is not specifically excepted, it is generally considered to be wages.

An employer must withhold FICA taxes from wages paid to an employee (sec. 3101). In addition, the employer must itself pay FICA tax on wages paid to a employee (sec. 3111). The definitions of FICA wages for purposes of withholding from an employee and the employer's tax are generally the same (sec. 3121).

The general definitions of wages for purposes of income tax withholding and FICA tax are the same. The detailed lists of exceptions from these definitions are generally similar, but they are not identical. Thus, certain payments may be wages for purposes of income tax withholding and not be wages for purposes of FICA taxes, or vice versa. The lack of conformity between these two definitions of wages may add complexity to some employer's payroll operations.

Possible Proposal

It would be possible to increase the conformity between the definition of wages for purposes of income tax withholding and the definition of wages for purposes of FICA.[51]

Analysis

It might simplify the payroll operations of employers if the lack of conformity between the income tax withholding definition of wages and the FICA definition of wages were minimized or eliminated. It might, however, not be possible to eliminate the lack of conformity since there may be policy reasons for the differences in the definitions of wages. For example, some of the differences may be attributable to the fact that the general philosophy of FICA is to tax wages that ought to be replaced when someone retires, dies, or becomes disabled, whereas the philosophy of income tax withholding is to tax all income paid as remuneration, which is a broader principle. On the other hand, withholding is generally the only means of collecting FICA, while income taxes can be collected via estimated tax payments or with the return where mandatory withholding is thought to be inappropriate. Consideration might nonetheless be given to examining any differences in the two definitions that are not due to policy reasons.

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[51] It would also be possible to increase the conformity between these two definitions of wages and the definition of wages for purposes of the FUTA tax (sec. 3306), which is paid by employers. Because the maximum amount of wages subject to FUTA tax is $7,000 per employee per year, however, the lack of FUTA conformity may in fact present no practical problems.

One example of the lack of conformity in these provisions is the rules relating to sick pay. Sick pay payments are generally made to an employee for each day the employee is sick and unable to work; the payments generally are a percentage (in many instances 100 percent) of the employee's normal wages for the period the employee is out sick. For income tax withholding purposes, sick pay paid by the employer is remuneration subject to withholding. Sick pay not paid by the employer (i.e., sick pay paid by a third party under an insurance arrangement with the employer) is subject to voluntary income tax withholding (sec. 3402(o)). All sick pay, regardless of who makes the payments, is subject to FICA taxes, except that sick pay paid after the expiration of 6 calendar months following the last calendar month in which the employee worked for the employer is not subject to FICA taxes (sec. 3121(a)(4)).

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